United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLEE

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74-2466

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

No. 74—2466

JOSE BORRELLO,

Plaintiff-Appellee,

against

PERERA COMPANY, INC.,

Defendant-Appellant.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF ON BEHALF OF APPELLEE

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February 27, 1975

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No. 74-2466

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-against-

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District Court For The Southern District
of New York

BRIEF ON BEHALF OF APPELLEE

STATEMENT OF ISSUE

Was the District Court correct in holding that a named payee of an ordinary check which fails to make inquiry of the maker and misapplies the funds, is not a commercially innocent party and may not invoke the defense of equitable estoppel to validate the misapplication?

STATEMENT OF FACTS

This action was brought by an Argentine resident against a New York corporation organized under the New York Business Corporation Law, engaged in the business of providing various foreign currency and exchange services (24a-25a).* The action sought recovery of $20,000, that being the total of two checks, each in the amount of $10,000, drawn on September 20, 1971, to the order of defendant (79a, 81a).

On September 20, 1971, the plaintiff went to his stockbroker in Buenos Aires, a company known as Waroquiers, S.A. (Q & A No. 23; 63a). He brought with him two checks each drawn by him on his New York City bank account maintained at the First National City Bank and each in the amount of $10,000. At that moment, the space on the checks for the name of the payee had been left to be filled in (Q & A Nos. 10, 11, 12, 13, 14; 61a). The name "Perera Co. Inc." was subsequently filled in as the payee by an employee of Waroquiers (Q & A Nos. 13,14; 61a). The transaction contemplated by the plaintiff and Waroquiers was carefully and precisely set forth in a written instruction from the plaintiff to Waroquiers issued contemporaneously with the delivery of the checks. That written instruction is as follows:

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* References followed by the letter "a" are to the appendix to appellant's brief; references preceded by "Q & A" are to questions and answers contained in plaintiff's deposition in evidence.

"September 20, 1971

Waroquiers, S.A.
Florida 656
B. Aires

Dear Sirs:

As we agreed in our conversation, I am sending you two checks Nos. 72 and 73 on the First National City Bank of New York, totaling $20,000, to be used for the buying of Argentine foreign Bonds 1971, to be delivered to a New York bank.

According to your request, these checks will be deposited with Perera Company, Inc. of New York in whose name they are drawn, as a guarantee of the availability of funds, so that you can receive the amount of the bonds upon delivering them to Perera Company, Inc. with a letter of mine addressed to them authorizing the payment.

When you send the two checks to Perera Company you should send them together with the necessary instructions for carrying out what we have discussed.

Without any more for the moment,

Sincerely,

Jose Borrello:" (84a)

The Waroquiers firm did not follow the plaintiff's written instructions, for the checks were not sent promptly and directly to defendant accompanied by the requested instructions. Instead the checks came into possession of a Uruguayan company having the name of Marfinco, S.A. Marfinco had maintained an account with defendant's Customer Credit Balance Department since June 1971 (34a).*

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* In September 1971, defendant's Customer Credit Balance Department maintained approximately 250 accounts (25a).

On September 20, 1971, Marfinco sent the two checks, with a group of others, to defendant, stating: "We enclose the following checks to be credited to our account with you:" (97a). The defendant followed the direction contained in Marfinco's forwarding letter; the checks were endorsed by defendant and the amount was then internally credited to the account of Marfinco (33a-34a, 37a).

At some time there was typed on the back of each check the following legend: "For deposit only -- Pay to the credit of Marfinco, S.A." (79a, 81a). The typed legend was then followed by the stamped endorsement of defendant which reads: "Pay to the order of Manufacturers Hanover Trust Company, New York, N.Y. For credit to the account of the First National Bank of Fleischmanns, Fleischmanns, N.Y. 144-7-35014--Perera & Co., Inc." (30a-31a, 79a, 81a). The head of defendant's Customer Credit Balance Department testified that he did not know who typed the legend above the stamped endorsement (33a), although he stated that he did not authorize the placing of the legend on the backs of the checks (48a). The District Court found:

> "At some time (apparently before Marfinco mailed the checks to Perera (see letter Ex.12)) some person typed on the back of each check (Exs.3 and 4) the legend: 'For deposit only--Pay to the credit of Marfinco, S.A.' No evidence of authority for any such transfer was ever submitted to this court." (106a)

It was undisputed that the plaintiff was not indebted to defendant as there had been no prior business transactions between them (107a). It was undisputed that defendant made no effort to contact the plaintiff when it received and deposited the checks (36a-37a), or at any later time between the deposit and the time plaintiff demanded return of his funds (37a). It was also undisputed that plaintiff had never heard of nor had any business dealings with Marfinco (Q & A Nos. 40-44; 65a-66a).

In November, 1971, the plaintiff received his regular bank statement from First National City Bank and that statement showed the appropriate debits for the two $10,000 checks (Q & A No. 46; 66a-67a; 95a). The cancelled checks were received with the bank statement (Cross Q & A Nos. 43-47; 75a-76a).

The plaintiff testified that he looked at the back of the checks at the time he received them with his statement from First National City Bank (Q & A Nos. 47-49; 67a), and that he believed that defendant was holding $20,000 to his credit (Q & A No. 54; 68a).

On February 15, 1972, certain newspaper articles caused plaintiff to become suspicious of the activities of Waroquiers (Q & A 50, 51; 67a) and he attempted to investigate the situation (Cross Q & A No. 34; 74a). As a result of his discoveries, the plaintiff, by letter dated March 30, 1972, requested that defendant

return the $20,000 to his checking account at the First National City Bank (85a).

From defendant's records (98a-99a), it appears that Marfinco maintained various widely fluctuating credit balances with defendant until February 17, 1972 (99a), when the then balance of $6,982.43 was transferred to a suspense account "to meet eventual claims and legal expenses" (99a). Subsequently, at the request of Marfinco and upon the advice of counsel (44a), defendant drew a check in the amount of $6,982.43 to the order of Marfinco. The check is dated March 24, 1972 but it was not paid by defendant's bank until May 17, 1972 (101a).

The District Court outlined the basic facts as follows:

> "This action is brought by Borrello, the maker of two checks, against Perera, the payee, who received these checks by delivery from a third party, Marfinco, S.A. ("Marfinco") and deposited the funds in its corporate account but internally credited the sum to an account maintained with it by the third party, Marfinco. From the facts shown at the trial the parties were unable to determine who placed the following typed legend on the back of the checks: 'For deposit only--Pay to the credit of Marfinco S.A." (104a)

ARGUMENT

POINT I

THE DISTRICT COURT CORRECTLY HELD THAT THE DEFENDANT WAS NOT A COMMERCIALLY "INNOCENT" PARTY AND THAT THE DEFENSE OF EQUITABLE ESTOPPEL WAS NOT AVAILABLE TO IT.

Appellant's brief states that its appeal relies exclusively "on the principles of equitable estoppel as set forth in Bunge Corp. v. Manufacturers Hanover Trust Co., 1972, 31 N.Y. 2d 223 and on the doctrine of proximate cause." (App. Br. p. 8). The "principle of equitable estoppel" was stated in Bunge Corp. v. Manufacturers Hanover Trust Co., 31 N.Y. 2d 223 (1972) as follows:

> "Where one of two innocent persons must suffer by the acts of a third, he who has enabled such third person to occasion the loss must sustain it." (31 N.Y. 2d at 228).

The Court below found the affirmative defense of equitable estoppel to be inapplicable to this case on several grounds, as follows: (1) the defendant was not a commercially "innocent" party; (2) the doctrine cannot be used to support transfer of the proceeds of an ordinary check, not in freely transferable form; and (3) no negligence or improper act of the act of the plaintiff "enabled" Marfinco (a third person) to persuade the defendant to divert the funds to it.

The District Court issued the following Conclusions of Law:

> "5. Defendant has failed to prove by a fair preponderance of the credible evidence that plaintiff was negligent or that, even if negligent, any of plaintiff's acts was the proximate cause of the loss (citations omitted).
>
> "6. The doctrine of equitable estoppel is not available to the payee in the case of delivery to it by a thief of an ordinary check requiring the endorsement of the payee; defendant's failure to take precautions and failure to make inquiry of plaintiff before disbursing the funds prevent defendant from being considered as a commercially 'innocent' party. (citations omitted).
>
> "7. Defendant has failed to prove by a fair preponderance of the credible evidence that plaintiff should be estopped from recovering his funds.
>
> "8. Plaintiff owed no duty to defendant to examine the checks and endorsements received by him from the First National City Bank; the duty of inspection and examination of returned checks is owed only by those in a bank-customer contractual relationship." (citations omitted). (115a-116a).

A. Defendant was not a commercially "innocent" party.

The District Court's analysis of the substantive law of New York governing the responsibility of a named payee was correctly stated in the following Conclusions of Law:

> "3. The designation of Perera as payee gave it notice that the checks were transferring to it funds of plaintiff: by collecting the checks and accepting and depositing the funds, Perera received plaintiff's property and was obliged to retain the funds subject to plaintiff's direction. (citations omitted)
>
> "4. Upon receipt of the funds and prior to any disbursements, it was the duty of defendant to make inquiry of the plaintiff as to the purpose for delivery of the funds. Since an inquiry would have disclosed immediately the purposes for which the checks were issued, defendant is chargeable with knowledge of the facts." (citations omitted) (115a)

In the instant case, defendant received the checks from a third party,(who was an absolute stranger to the checks, being neither maker, drawee nor payee) and then effectively reduced the checks to cash for the benefit of the third party, by depositing the checks in its own account and internally crediting the sum to its customer's account so that the funds could be withdrawn by its customer. These steps were taken by the defendant without a single inquiry as to the purpose for which it had been named as payee by the plaintiff, a stranger to it. Defendant blindly followed the instructions of its dishonest customer despite the fact that the instructions were inconsistent with the checks themselves, which named the defendant, not Marfinco, as the payee.

The New York Courts have firmly held that a named payee may not apply the proceeds of a check to a third party without

first making inquiry of the maker and they have repeatedly rejected the affirmative defenses of estoppel and contributory negligence, even where the third party was an agent or employee of the maker.*

In the leading early case of Sims v. U. S. Trust Company, 103 N.Y. 472 (1886), the plaintiff delivered his check, drawn on the People's Bank and payable to the order of U. S. Trust Company, to Crowell, with verbal instructions to deposit the funds with U. S. Trust Company. Crowell, when he delivered the check to U. S. Trust Company, requested delivery of a certificate of deposit payable to himself as trustee for the plaintiff. Crowell later cashed the certificate and appropriated the funds. The Court of Appeals stated:

> "The use of the defendant's name as payee of the check indicated the drawer's intention to lodge the moneys in its custody and place them under its control, and nothing further than this was inferable from the language of the check. . . .
>
> "The defendant could have refused to receive the deposit or act as Dr. Sims' agent in transferring the funds from one custodian to another; but having accepted the office of so doing, it was bound to keep Dr. Sims' moneys, until it

---

* In the case at bar, Marfinco was not an agent or employee of the plaintiff, but was presumably a thief who took from plaintiff's broker Waroquiers.

> received his directions to pay them out. The language of the check making the funds payable only upon the order of the defendant imposed upon it the duty of seeing that they were not, through its agency, improperly disbursed after it had received them. They could not safely pay out such funds except under the direction of their lawful owner." (Emphasis added.) (103 N.Y. at 476)

In Arrow Builders Supply Corp. v. Royal National Bank, 21 N.Y. 2d 428 (1968), an employee of plaintiff caused plaintiff to prepare checks drawn on its account in the defendant's bank, payable to the order of that bank. The dishonest employee presented the checks to defendant's bank and requested the bank to issue its own check for the same amount payable to a person designated by the dishonest employee. The Court of Appeals stated:

> "At the outset, it should be noted that the defendant was negligent, in disbursing plaintiff's money without receiving proper instructions and without having made any inquiry (Citations omitted). In receiving checks payable to itself, and signed by the plaintiff's president the bank properly presumed that these checks had commercial significance. In such a situation, the bank cannot possibly ascertain this significance by merely relying on the directions of one who is without either actual or apparent authority to represent the drawer." (21 N.Y.2d at 431)

The very recent case of Federal Insurance Company v. Groveland State Bank, 44 A.D.2d 182, 354 N.Y.S.2d 220 (4th Dept. 1974) illustrates the basic principles of law governing the instant case and discusses the leading New York cases on the subject. In that case, an employee of Lincoln Rochester Company (plaintiff's assignor) secured the execution of a series of checks to the order of Groveland as named payee. Lincoln was the drawee as well as the drawer. The employee had established an account with Groveland, and when he delivered Lincoln's check to Groveland, he requested that the funds be credited to his account. Groveland, as payee, endorsed the checks for collection, received payment of the funds and then credited them to the dishonest employee's account. The funds were subsequently withdrawn by the dishonest employee. The Appellate Division granted summary judgment in favor of the plaintiff. There was no dispute that Groveland had made no inquiry whatsoever with respect to the deposit of the maker (drawer) of the checks, and that there had been no previous business relationship between Lincoln and Groveland. The Court stated:

> "On their face the checks which lacked any designation of a remitter, demonstrated that the funds represented by them belonged to the drawer Lincoln. The designation of Groveland as payee gave notice absent any obligation between drawer and payee, that the instruments

> were transferring to the payee funds of the drawer; by collecting the instruments and accepting such funds the payee received property of the drawer and was obligated to retain such funds subject to the direction of the owner.
>
> . . .
>
> "In the instant case, the undisputed facts are that Groveland, as payee on the checks of Lincoln, received the proceeds of the checks and disbursed the same to its depositor Jaquish, without inquiry of the drawer-owner as to the proper disposition of the funds, despite the absence of any showing of entitlement to the checks or to their proceeds on the part of Jaquish, whose name appeared nowhere on the instruments. Such disbursement entitled plaintiff to recover back the funds belonging to it in an action for money had and received. (Citations omitted)." (emphasis added) (354 N.Y.S.2d at 225, 226)

The requirement for inquiry developed in the law because the situation presented in the instant case, as well as in the cited cases, is inherently suspicious. If a maker intends the proceeds of his check to be for the benefit of the person to whom the check is initially delivered, the normal and usual method would be for the maker to draw the check to the order of that person.

In the instant case, the following commercial facts and circumstances must be considered to be known to the defendant at

the time it deposited the checks to its account and then credited Marfinco's personal account with the sum of $20,000:

(1) The checks were payable to defendant rather than to Marfinco; and it was, therefore, clear that Marfinco had not acquired ownership of the checks by negotiation and that the typed, unsigned, legend on the back could not be an endorsement;

(2) the checks were ordinary personal checks rather than cashiers checks or bank money orders; ordinary checks are not normally "purchased" and defendant had no evidence that Marfinco had actually purchased the checks from the plaintiff;

(3) there was no indication on the face of the checks concerning the purpose for which they had been issued;

(4) the checks did not relate to actual transactions between plaintiff and defendant;

(5) the checks were each substantial in amount.

In the face of these suspicious circumstances, defendant's officer testified that its procedureswere totally unconcerned with the name of the payee (31a) as the only examination that was made was to see if the checks were stale and if they were drawn on United States funds (29a). The testimony also showed that the typed legend on the back of checks was also of no concern to defendant, since any minor employee could be authorized to stamp the defendant's endorsement on the checks below the legend (30a). Defendant's testimony attempted to convince The District Court

that under defendant's procedures, it automatically, and without examination, treated all commercial paper received as "bearer" paper. The District Court apparently refused to believe that the defendant routinely handled large financial transactions in such a "casual" manner.*

Appellant argues, without citing authority, that the duty of inquiry imposed upon a payee by the New York law should be disregarded in this case because one can only conjecture as to what would have been the result of such an inquiry and that it was likely to be futile (App.Br. pp. 11, 17). But even if an inquiry would have been futile or difficult,** the law does not allow the payee to disregard his obligation and nevertheless keep the money for himself. There is little doubt that defendant could have rejected the checks and the transaction and plaintiff could not have imposed upon it the obligation of acting as a depository of the funds. But what defendant could not do, is accept the funds of a stranger, deposit them in its account and subsequently pay them out to a third party without inquiring of the maker as to the purpose for the checks and finding out that purpose. Even a

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* Although not essential to its determination, the District Court found that the method of the conversion of the funds showed "...a clear-cut case of plain chicanery on the part of defendant." (108a)

** Since the checks were drawn on the First National City Bank in New York City, there is no reason to believe an inquiry would have been difficult. The District Court properly concluded: "Since an inquiry would have disclosed immediately the purposes for which the checks were issued, defendant is chargeable with knowledge of the facts." (115a)

failure to find out the purpose could not justify the defendant treating the funds as its own to be kept or paid out without restriction.

The law does not permit a payee to escape its duty to inquire of the maker the purposes for the issuance of the checks and the instructions for disposition of the proceeds; a payee is chargeable with knowledge of the true facts.

In Munn v. Boasberg, 292 N.Y. 5 (1944), the plaintiff had given Shuman, a third party, a check made payable to the order of defendant, upon Shuman's representation that it was needed to pay certain debts of a country club. Instead, Shuman delivered the check to the defendant, President of the club, with the request that it be used to satisfy Shuman's personal debt to the club. The Court of Appeals stated:

> "The check, being drawn by the plaintiff to the order of the defendant, imported on its face that the money represented by it was the plaintiff's property and that the plaintiff, not Shuman, was paying it to the defendant. Shuman had no apparent title to the check and was therefore to be regarded as the agent of the plaintiff for the purpose of delivering the plaintiff's check to the defendant. . . .
>
> "Under the provisions of the Negotiable Instruments Law. . . the burden was cast upon the defendant to prove that he, or some

> person under whom he claimed, acquired title to the check as a holder in due course. This he could not do because the check itself was constructive notice that the funds it represented were funds of the plaintiff which could not be applied in payment of the agent's personal indebtedness without inquiry of the principal. Such an inquiry might well have disclosed immediately the purpose for which the check was delivered. The defendant was therefore chargeable with knowledge of that fact. Nor is this a case in which a payee of a check could acquire the title of a bona fide purchaser for value. Shuman was not a remitter who had acquired the instrument by purchase." (Emphasis added.) (292 N.Y. at 8, 9)

These rules were very clearly set out in the case of Fidelity & Casualty Co. of N. Y. v. Hellenic Bank Trust Co., 181 Misc. 40, 45 N.Y.S.2d 43 (1943), aff'd mem. 181 Misc. 44, 47 N.Y.S.2d 295 (App. Term, 1st Dept. 1943).* In that case, an employee (Emmens) of Great American Insurance Company caused four checks of that company to be signed by the appropriate officers, drawn on the First National Bank and made payable to the order of Hellenic Bank Trust Co. There had been no relationship whatsoever between Great American Insurance Company and Hellenic, and there was no indebtedness of any kind between them. Emmens took the checks to Hellenic where he was a depositor.

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* This case was cited with approval by the New York Court of Appeals in Arrow Builders Supply Corp. v. Royal National Bank, 21 N.Y.2d 428, 431 (1968).

Hellenic allowed Emmens to deposit the check, and the Bank credited Emmens' account and allowed him ultimately to withdraw the funds. The Court stated:

> "The checks were not bearer instruments; although they were procured by the fraudulent act of the employee of plaintiff's assignor, they were nevertheless made payable to an existing payee, this defendant, to whom, and not to a ficticious or non-existent person, the drawer intended them to be payable. . . . Therefore, when Emmens brought the checks to defendant and asked that they be deposited in his account to his credit, it was the duty of the defendant to ascertain why, for what purpose, his employer had issued checks to its, defendant's order, although not indebted to it. The mere possession of the checks by Emmens did not give him the right to their proceeds. It did not confer upon him ownership or apparent ownership; it did not endow him with authority, actual or apparent, to make use of the checks. 'Possession of a bill or note unendorsed by the payee is not of itself evidence of title. It may have been acquired by fraud or theft.' [Citation omitted.] Hence, the defendant bank could not escape the duty of making proper inquiry." (Emphasis added.) (45 N.Y.S. 2d at 44)

The New York courts have long held that a failure to inquire in suspicious circumstances constitutes commercial "bad faith". In these circumstances, "bad faith", does not require actual dishonesty on the part of the payee but only requires a

failure to take precautions or to make inquiries whenever the transaction is inherently suspicious. This general rule was first stated in Rochester & Charlotte Turnpike Road Co. v. Paviour, 164 N.Y. 261 (1900) as follows:

> "Even if [the purchasers'] actual good faith is not questioned, if the facts known to him should have led him to inquiry, and by inquiry he would have discovered the real situation, in a commercial sense he acted in bad faith and the law will withhold from him the protection that it would otherwise extend." (164 N.Y. at 284)

See also Soma v. Handrulis, 277 N.Y. 223, 233-34 (1938).

In Ward v. City Trust Co., 192 N.Y. 61 (1908), the defendant accepted a check made out to the order of a corporation in payment of a personal loan of the sole stockholders and officers of the corporation. Defendant knew of the stock ownership and made no inquiry as to the authority of the officers or the financial solvency of the corporation. The Court held that the form of the check was sufficient to put the defendant on notice that the funds presumptively belonged only to the named payee, requiring defendant to make inquiry. It concluded that the failure to make the required inquiry which would lead to the discovery of the true situation amounted to commerical "bad faith". (192 N.Y. at 73-74, 76).

The Court below, in concluding that the defendant was not an "innocent" party who could claim the benefit of a transfer by equitable estoppel, cited Rochester & Charlotte Turnpike Road Co. v. Paviour, supra, and Federal Insurance Company v. Groveland State Bank, supra (112a, 116a). The Groveland State Bank Case met the question of equitable estoppel directly and concluded that Groveland's action in receiving the funds and paying them out without inquiry, disqualified it from being treated as an "innocent" person. The Appellate Division therefore, found the Bunge Case, supra, to be inapplicable (see 354 N.Y.S.2d at 228).

Appellant's brief (p. 15) incorrectly argues that the Groveland State Bank Case and the Bunge Case are inconsistent. There is no inconsistency at all. The Groveland State Bank Case holding on this point simply follows the principle established in the Rochester & Charlotte Turnpike Road Co. Case, as regularly followed by the New York courts for over seventy years. The Bunge Case made no attempt to overrule these extensive precedents, for the type of instrument involved in that case did not put the bank on notice and require inquiry. The New York Court of Appeals specifically recognized that the presumption raised by the form of the instrument was in favor of the bank and not, as in the instant case, against the claim of the defendant. It held:

> "It is generally accepted in banking law that a bank, absent notice of delivery... is permitted to accept

> official checks back from the remitter on the presumption that the remitter is still the owner of the checks." (31 N.Y.2d at 230-231)

As the many authorities cited above show, in the case of an ordinary check drawn by a stranger in favor of a named payee, the presumption is against the proceeds being owned by a third party who is a complete stranger to the check. The payee is thereby put to an inquiry before disbursing the funds to the third party.

Accordingly, the District Court was entirely correct in holding that the defendant's claimed "casual" procedures, failure to take precautions and failure to make inquiry, prevented it from qualifying as an "innocent" party, able to acquire title by estoppel.

B. The doctrine of equitable estoppel cannot be used to support transfer of the proceeds of an ordinary check, not in freely transferable form.

Even assuming, arguendo, that the defendant's failures referred to above do not destroy its claim of commercial "innocence" and do not disqualify it from claiming an equitable estoppel, the defendant's claim to ownership of the funds must nevertheless fail.

The New York Court of Appeals in the Bunge Case based its reliance on the doctrine of equitable estoppel upon the cases of People v. Bank of North America, 75 N.Y. 547 (1873) and People's Trust Co. v. Smith, 215 N.Y. 488 (1915). (See 31 N.Y.2d

at 229-230). Both cases involved questions of a transfer of title on the theory of "an estoppel by negligence". The case of People v. Bank of North America, supra, involved ten drafts which were entrusted to an employee with instructions to deposit them. The employee negotiated the drafts elsewhere for his own benefit. Eight of the drafts were unendorsed except by the employee's forgery and two of the drafts had been endorsed in blank by an authorized person and were freely negotiable in form. The Court rejected the theory of transfer by estoppel with regard to the eight drafts which were delivered to the employee in non-negotiable form, and accepted the theory with regard to the two drafts that became bearer paper as a result of the endorsements in blank. The doctrine of a transfer by estoppel was explained as follows:

> "It certainly is not a general rule of law that a person can be deprived of property by an unauthorized transfer thereof, simply because he has not exercised ordinary care to prevent such a transfer. I may intrust a dishonest person with my personal property, and thus put it in his power to sell it; and yet it has never been held that in such a case my carelessness will deprive me of the right to reclaim my property, the person thus intrusted having neither the real nor apparent power to sell it. I may place my unindorsed bills in the hands of an agent, and thus place it in his power to forge an indorsement; and yet the indorsement would not bind me. The principle that when one of two persons, equally innocent, must suffer a loss by the act of a third person, he shall

> bear the loss who placed it in the power of such third person to perpetrate the act, does not apply to such cases. Where it is said in the books that one is estopped by his negligence as to the acts of another who has assumed to act for him, or to deal in his property, the negligence meant is that of permitting such other person to clothe himself or to be clothed with apparent authority to act, and then the person who has been induced to rely and act upon the appearances can invoke the estoppel; (75 N.Y. at 561-562).

Plaintiff's delivery of the checks to his stockbroker with specific instructions, did not permit Waroquiers or Marfinco the appearance of having authority to negotiate or appropriate the checks. The checks were not, and could not be negotiated by anyone but the defendant; that was the protection arranged for by the plaintiff. Equally, plaintiff's supposed "omission" in not alerting defendant before it further acted upon its dishonest customer's instructions and disbursed the funds (see App.Br. 12), did not make it appear that Marfinco had authority to later collect funds to the eventual disadvantage of the plaintiff.

The distinction made in People v. Bank of North America, supra, between the eight drafts which could not be negotiated without endorsement, and the two drafts, which had been endorsed in blank and were in bearer form, is essential. Justice Cardozo, in People's Trust Co. v. Smith, supra, emphasized the same distinction, as follows:

> "But the mere possession of a chattel with the permission of the owner does not enable the possessor to transfer a title by estoppel. What is true of a chattel is true equally of things in action. ...We are asked to apply to this case the rules of estoppel that govern the assignment of stock certificates... and some other commercial documents... when indorsed in blank. The supposed analogy is deceptive.... The owner who intrusts to another a stock certificate thus indorsed has given currency to an instrument which connotes by its very form a contemplated transfer. In such circumstances, if the agent proves to be dishonest, the owner must bear the loss... There is little analogy between a commercial document with an indorsement which, by commercial usage, is an invitation to purchase it, and a bond and mortgage unaccompanied by any instrument of transfer." (215 N.Y. at 493-494).

In the Bunge Case, the New York Court of Appeals was very careful to adhere to the distinctions emphasized in People v. Bank of North America and People's Trust Co. v. Smith. The Court repeatedly declared that the checks involved in that case were "official checks which are negotiable instruments...freely returnable to the issuing bank when in the hands of the remitter." (31 N.Y.2d at 228, 229, 231). The checks, when returned to the issuing bank were in exactly the same physical state as when issued; there was no way for Manufacturers to determine that they had

been delivered. As Judge Breitel noted in his dissent in the Bunge Case, all similar New York cases applying the doctrine of equitable estoppel prior to the Bunge Case, involved bearer paper, or paper or securities endorsed in blank (31 N.Y.2d at 235 fn.2). The Bunge Case extended the doctrine of equitable estoppel to returned official cashier's checks because such paper is "freely returnable to the issuing bank when in the hands of the remitter." To extend the doctrine to the instant case of an ordinary check requiring the endorsement of the payee, would represent a major departure from existing New York case law and would completely obliterate the careful distinctions made in People v. Bank of North America, supra, and People's Trust Co. v. Smith, supra.

C. No negligence or improper act of the plaintiff "enabled" Marfinco to "occasion the loss".

Appellant argues in its brief that the plaintiff had "the last clear chance to prevent the loss" and that defendant's conversion of funds should be excused because an opportunity to recover the funds from Marfinco may have existed (App. Br. p.9). The argument is that the plaintiff's failure to be alerted to the possibility of a later misapplication of funds when he observed the typed legend on the back of the checks returned to him by his bank and his failure then to take immediate action to assure himself that defendant had been properly instructed, was the "final" negligence which caused the financial loss.

The District Court concluded:

> "Plaintiff owed no duty to defendant to examine the checks and endorsements received by him from the First National City Bank; the duty of inspection and examination of returned checks is owed only by those in a bank-customer contractual relationship." (116a)

As stated in Federal Insurance Co. v. Groveland State Bank, supra:

> "Other than as Sections 3-406 and 4-406 of the Uniform Commercial Code may have provided with regard to unauthorized signatures and alterations, there is no authority for extending the duty of inspection and examination of returned checks to benefit those outside the depositor-bank relationship. Any such extension may better take the same path as that traveled by the section last referred to, culminating in legislative amendment." (emphasis added) (354 N.Y.2d at 228)

Appellant appears to concede that the duty to examine returned checks exists only between a bank and its customer, but argues that a duty to report to the payee exists, if an examination in fact does take place (App.Br. p. 13). The cases cited by Appellant do not support the argument. The duty to discover and and the duty to report discoveries have not been separated in the law and those duties have been set out in Section 4-406 of the Uniform Commercial Code. The duties relate only to customers with

respect to their banks. If there is no duty, there can be no breach of a duty and no negligence. See Wagner Trading Co. v. Battery Park National Bank, 228 N.Y. 37, 41 (1920).

The case of Federal Savings & Loan Insurance Corp. v Kearney Trust Co., 151 F.2d 720 (8th Cir 1945), applying Federal law, bears a factual similarity to the instant case. The defendant bank had stamped the back of the checks: "The Amount of this Item Deposited to the Credit of Harold and/or Evalyn Wilson, Farm Acct. in the Kearney Trust Co., Kearney, Mo.". The defendant claimed that the plaintiff should be estopped because it should have discovered the misapplication of funds and notified the defendant after it had received the account statement and cancelled checks forwarded by the drawee bank. The Court rejected the defense on the ground that the defendant, having failed to make inquiry of the maker prior to making the funds available to the third party, was not an "innocent" party for the purpose of applying principles of estoppel. The Court, therefore, completely rejected the idea that a "last clear chance" doctrine might apply.

Additionally, there is no justification for Appellant's assumption that the legend typed on the back of the checks was sufficient to alert the plaintiff, as a matter of law, to the possibility that the defendant could later permit the withdrawal of the funds for the benefit of a third party. Since defendant,

as named payee, could negotiate the checks, so long as it remained ultimately responsive to plaintiff's instructions, the plaintiff was in no way alerted to the fact that the funds had been internally accounted for in such a way as to make them available to a third party claiming ownership. There was no way for plaintiff to determine whether or not defendant itself had placed the legend on the back of the checks. In fact, defendant's stamped endorsement did not indicate a deposit to its own account, but an unexplained transfer of funds to the credit of another stranger, the First National Bank of Fleischmanns (79a, 81a).* Money being fungible, plaintiff could not be concerned with the manner of defendant's internal treatment of these particular checks, so long as defendant held $20,000 subject to plaintiff's instructions. The plaintiff's inability to guess from the backs of the checks that a dishonest scheme was involved was not negligence and in no way was responsible for the diversion of the funds. No act or omission of the plaintiff made it appear that Marfinco had authority to later collect funds to the eventual disadvantage of the plaintiff; and no act or omission of the plaintiff induced the defendant to surrender the funds to Marfinco. See Matteawan Manufacturing Co. v. Chemical Bank & Trust Co., 244 App. Div.

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* The endorsements read: "Pay to the order of Manufacturers Hanover Trust Company, New York, New York, for credit to the account of the First National Bank of Fleischmanns, Fleischmanns, N.Y." (79a, 81a). It was only through testimony that it appeared that the defendant had an account with the Fleischmanns bank (31a). The District Court referred to defendant's handling of the checks as "involved manipulations". (111a) A maker is not responsible for the discovery of even an unauthorized endorsement. See Shipman v. Bank of The State of New York, 126 N.Y. 319, 328 (1891).

404, 279 N.Y. Supp. 495 (1st Dept. 1935), aff'd, 272 N.Y. 411 (1936); Fidelity & Casualty Co. v. Hellenic Bank Trust Co., supra. Appellant's claim that the "proximate cause of the loss was the plaintiff's failure to react when he received his cancelled checks" (App.Br. p.10) was properly rejected by the District Court as being unsupported by either the facts or the law. The possbility that defendant might have successfully reclaimed the funds from its customer in a third party action or by attaching its customer's account if the plaintiff had earlier guessed the scheme and notified defendant,* does not excuse the defendant from the liability imposed by its payment to a stranger without proper inquiry. Defendant's claim that it paid out the money under an innocent "mistake of fact" (App.Br. pp.12-13) might have some meaning in an action for recovery of the funds against

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* Marfinco's widely fluctuating account (98a-99a) does not prove that the account could be successfully attached at any given time. Defendant's final check in favor of Marfinco was not paid by the drawee, National Bank of North America, until May 17, 1972 (101a), two and one-half months after defendant had received plaintiff's request to return its funds (85a). Obviously defendant could have stopped its check in favor of Marfinco if it was so inclined. In addition, the endorsement on the check reveals that Marfinco deposited the money in a New York bank account. It was not shown that defendant had no way of recovering over, although it was assumed throughout the trial that the Marfinco firm was controlled by a thief.

Marfinco, but it has no meaning in an action by the plaintiff the true owner of the funds.*

. . . .

It must be concluded that (1) plaintiff was not "negligent" by reason of its delivery of the checks to his stockbroker or his "omission" in not suspecting a diversion of funds; (2) defendant's failure to take ordinary precautions and failure to make proper inquiry prevents it from being treated as an "innocent" party and prevents it from raising the defense of estoppel by negligence or equitable estoppel; and (3) the equitable estoppel principle employed in the Bunge Case, supra, in any event does not apply to ordinary checks, payable to the order of a named payee and not transferable without endorsement.

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* The case of Wilmerding v. Postal Telegraph Cable Co., 118 App. Div. 685, 103 N.Y. Supp.594 (1st Dept. 1907) aff'd. mem. 192 N.Y. 580, cited at page 16 of Appellant's brief, stands for the proposition that the plaintiff's negligence in not discovering that it was being cheated, did not bar its recovery.

CONCLUSION

The judgment of the District Court should be affirmed.

Respectfully submitted,

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February 27, 1975

Receipt and timely service of TWO copies
of the within BRIEF is hereby
admitted this 27TH day of FEBRUARY, 1975

Attorneys for APPELLANT